H&R REIT's Q1 2021 Financial Results

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9:30 AM

Operator: Good morning, and welcome to H&R Real Estate Investment Trust 2021 first quarter earnings conference call.

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I would now like to introduce Mr. Tom Hofstedter, chief executive officer of H&R REIT. Please go ahead, Mr. Hofstedter.

Tom Hofstedter: Good morning, everyone. I'd like to thank you all for joining us here today. With me on the call are Larry Froom, our CFO, Pat Sullivan, COO of Primaris, Philippe

LaPointe, COO Lantower, Alex Avery, executive vice president, acting management and strategic initiatives, and Robyn Kestenberg, executive vice president, corporate development.

It has now been over a year since the pandemic began (inaudible). The past year has had its challenges, and our Q1 results will be impacted by the difficulties some of our tenants face. REIT's business, however, has shown stability, resilience, despite a few notable areas of softness. We have continued to work hard to position H&R for success as the pandemic impact fades and the economy reopens broadly.

I'll turn it over to our team to provide details of the first quarter 2021 financials and operating results. Philippe will review our multi residential operation. Following that, Pat will provide an update on our retail portfolio, and Larry will provide some context on financial results. And finally, I'll make some closing remarks. Philippe, over to you.

Philippe LaPointe: Good morning, everyone. We've got some notable updates for this quarter, and so, I'm delighted to share the latest from Lantower Residential.

On the JV development front, the Pearl in Austin, Texas is scheduled to fully deliver its third quarter above 2021. Nightingale in Seattle is in the early stages of preleasing, and the project will be fully delivered this year. Construction of

phase two of our Hercules apartment--I'm sorry--development, named The Grand, has remained on schedule and is expected to deliver in the second quarter of 2021. Lastly, Shoreline Gateway, our 35 story tower in Long Beach, California, is also on schedule and expected to be delivered in August 2021.

As mentioned last quarter, we plan to supplement our JV development partnerships with our wholly owned development platform within Lantower. First, I would like to provide an update on our infill site in Dallas, Texas with proximity to the Dallas Love Field airport and medical district. The plan for the 5.4 acre site that we refer to as West Love is a five story wrap community with approximately 413 units. We are finishing schematic designs as we speak and will be moving through the drawing process throughout the year with a target date to break ground by the end of this year.

Additionally, on January 28th, we purchased a 4.2 acre infill site with direct frontage to the North Central Expressway, one of the most trafficked thoroughfares in the core of Dallas. We are also in schematic design with this high story wrap product that will include approximately 350 units.

Lastly, we are finishing up schematic designs for a garden style property in Tampa, Florida. This development, with approximately 270 units, is adjacent to Highway 19, one of the

most dominant thoroughfares in all of Pinellas County. The development is located on an infill location characterized by low future supply and healthy rental growth. Also of note, we originally purchased the site with entitlements for approximately 200 units. However, upon working with the local municipalities, we were able to increase our density to our current level at no cost, resulting in an increase in development yield.

In light of our strategic shift towards ground up development to take advantage of the wide spread between development yields and prevailing cap rates, we look forward to sharing more exciting development updates in the future.

On the Lantower River Landing front, our leasing pace continues to beat expectations and budget. As of today, we are 45 percent occupied and have leased over 280 apartments. For context, our budgeted number of occupied units at this time was approximately 200, underscoring the strength of our lease up efforts at River Landing despite increasing our asking rents multiple times to keep pace with the overwhelming demand for our property.

Perhaps most importantly, we would like to share an update on Jackson Park. While the return to stabilization will largely be driven by the workers returning to the office and students

returning to the classroom, we are very encouraged by the return to normalcy in New York City. Social activity is resuming with the successful rollout of the vaccine and the declining new COVID case numbers. Just last week, New York City increased their restaurant capacity from 50 percent to 75 percent, and the mayor has targeted a full reopening by July.

The property is expected to gain positive absorption as we enter the favorable summer leasing season, a trend that we are already beginning to observe with an increase in traffic. For context, we received nearly 700 pieces of prospect traffic in March and April, compared to only 156 pieces of traffic in March and April of last year.

In the span of last month, when including pending applications, we have gone from 60 percent leased to 69 percent leased. We remain confident that Jackson Park is one of the best value propositions for prospective residents in the submarket when considering location, amenities, and quality of construction.

On the financial front, when excluding Jackson Park, our same asset quarter over quarter operating income growth equates to a positive 4.1 percent for the first quarter of 2021 compared to the first quarter of 2020. We are proud to announce that Q1 operating income growth represents over 12 straight quarters of

same asset quarter over quarter positive NOI growth, when excluding Jackson Park, a feat that we are particularly proud of when considering the tumultuous 2020.

And with that, I will pass along the conversation to Pat.

Patrick Sullivan: Thanks, Philippe, and good morning, everyone.

Following an encouraging fourth quarter from the retail segment, Q1 same asset NOI declined $8.3 million or 13.4 percent from Q1 2020, including an 18.5 percent decline from enclosed malls. For enclosed malls, temporary rent reductions accounting for 34 percent of this decline; 28 percent relate to rent reductions we view as being more lasting in nature; 11 percent related to lower percentage rents, specialty leasing, and miscellaneous revenues; and the remaining 27 percent was due to vacancy, net and new leases commencing. Notably, bad debt expense has declined sharply from the highs of last summer.

Throughout the pandemic, our primary focus has been to maintain occupancy. Occupancy at the end of the first quarter was 91.5 percent for the retail division as compared to 92 percent at the end of Q4 and 91.1 percent at the end of Q1 2020. And closed malls contribute 55 percent of the NOI in the retail division, with grocery anchored centers generating 28 percent of the NOI and other retail contributing just under 17 percent.

For enclosed malls, occupancy at the end of Q1 2021 remained relatively stable at 87.2 percent, compared to 88.1 percent at the end of Q4 2020 and 86.7 percent at the end of Q1 2020. The pandemic has impacted some retailers more than others, with some filing CCAA as a measure of last resort.

To maintain occupancy, we agreed to provide rental relief or restructured rental terms on a short term basis to those tenants whose business has been significantly impacted by the pandemic and others that may have otherwise closed as part of their CCAA filing. Revised terms typically involve lower base or gross rent plus a percentage rent over a reduced sales threshold.

With these temporary lease terms in place, our rental revenue takes on a greater seasonality consistent with the seasonality of our tenants' sales. Our fourth quarter results benefited from the seasonally high fourth quarter tenant sales. However, Q1 results were negatively impacted due to first quarter sales, typically representing the lowest share of annual sales compared to other quarters.

To better understand the increased seasonality impact of our revised rental terms, in Q1 percentage rate in lieu (sp) accounted for four percent of retail rent up from two percent in Q1 2020, with percentage rent accounting for a higher share of a

lower total rent. By comparison, in Q4 2020, percentage rent accounted for 12 percent of total rent, compared to four percent in Q4 2019.

In addition to the amplified seasonality of temporary lease amendments, Q1 results were impacted by the fact Ontario, Manitoba, and Quebec malls were closed for a portion of the first quarter, with malls in other regions being impacted by occupancy restrictions.

Over the balance of the year, we anticipate higher contribution from revenue categories, including percentage rent and specialty leasing, as malls reopen, restrictions ease, as well as a result to new normal lease terms for many tenants currently subject to temporary lease amendments.

Collection of rents in the retail portfolio continue to trend higher since a low point in May 2020. In Q1 2021, we collected 89 percent from our enclosed malls and 92 percent from the retail segment overall. This is an improvement from the 87 percent collected from our enclosed malls and 90 percent from the retail segment in Q4. While the RAYPO (sp) rent collection statistics lagged the Q1 2021 figure, we expect improvement, in time, as we have consistently seen in prior periods. With malls in Ontario being closed again and occupancy restrictions

tightened in Alberta and Manitoba, we expect continued drag in performance during Q2 and Q3.

On a positive note, we have seen good leasing traction, as retailers anticipate a return to more normal operating conditions. During the first quarter, we completed 98 lease transactions, representing 475,000 square feet, of which 30 were new deals. The 30 new transactions completed is greater than the figure posted during the first quarter of each, Q1 2020 and Q1 2019. Our leasing team continues to have positive discussions with retailers about opening new stores across the portfolio, and we believe that we will continue making progress improving our occupancy levels throughout the remainder of the year.

In terms of impact, we anticipate $1.9 million incremental contribution from new lease commencements in 2021 with large format tenants--excuse me--we anticipate $1.9 million in incremental contribution from new lease commencements, with large format tenants, during the remainder of 2021, including rents from the new 39,000 square foot Save-On-Foods store that opened from a portion of the former Sears box in Kildonan Place at the end of April 2021.

In addition, we’ve completed or are in the final stages of completing significant transactions that will create incremental

rental growth of over $3 million in 2022, including a 27,900 square foot lease with the city of Toronto to occupy second floor office place at Dufferin Mall, at rates 1.8 times higher than the prior tenant. The former office tenant vacated at the end of 2020, with new rents expected to commence December 2021.

Last summer, our malls had recovered well following the closures in the spring of 2020, with sales in the third quarter climbing to 83 percent of Q3 2019 figures. However, mall closures and occupancy restrictions reinstated in Q4 have resulted in notable sales declines, which have continued for the first quarter. Sales for the first quarter were 66 percent of first quarter sales last year, adjusted for late March declines.

Sales during Q4 were 69 percent of Q4 2019. Our four malls in Ontario, which typically account for 31 percent of annual portfolio mall sales, were particularly impacted by mall closures, having reported Q1 '21 sales equal to 41 percent of prior year comparable period. With the majority of our malls being located in secondary markets and typically the only regional mall in their trade area, once closures and restrictions were lifted, properties have shown solid gains.

By way of example, a (inaudible) mall sales have rebounded in 90 percent of pre pandemic levels in February and March, following the mall being closed in January. In areas where

malls have been open, but operating with restrictions, sales have been relatively strong. Malls in Alberta posted 77 percent of pre pandemic sales in Q1, despite retailers having occupancy limits in place.

Orchard Park in Kelowna reported 85 percent of former year sales during Q1 with our New Brunswick malls at 81 percent. Based on feedback from retailers that also offer in the United States, we are optimistic that our malls will return to pre pandemic sales levels once restrictions are lifted.

To close, we would like to provide an update on our redevelopment plan for Dufferin Mall. In July 2019, we submitted combined applications for rezoning and redevelopment for the north end of the property to create Dufferin Grove Village.

The project is anticipated to include approximately 1,200 residential rental units. Discussions with the city are progressing, and we anticipate rezoning and site plan approval in Q4 2021 and commencement of construction Q4 2022. Upon completion, this redevelopment project will transform a successful established inner city regional shopping center into a vibrant mixed use development.

Thank you, and I will now turn it back to Larry.

Larry Froom: Thank you, Pat, and good morning, everyone. I'll start with our balance sheet. As of March 31, 2021, debt to total asset was 46.7 percent compared to 47.7 percent as of December 31, 2020. A weighted average interest rate of H&R's debt as of March 31, 2021 was 3.6 percent with an average term to maturity of 3.6 years.

As of March 31, 2021, liquidity was $55 million of cash in hand and $1.4 billion of unused borrowing capacity available under our lines of credit. In addition, we have an unencumbered property pool of approximately $3.9 billion.

With the onset of COVID last year, we increased our liquidity to approximately $1 billion. The increase in current liquidity to $1.4 billion is expected to return to more normal levels as we expect to either utilize part of our unused facilities to repay mortgages or decrease some of the facilities.

Bad debt expense has steadily decreased from $23.5 million recorded in Q2 2020, with the onset of COVID, to $12.6 million in Q3 2020, $3.2 million in Q4 2020, and now $1 million in Q1 2021. At March 31, 2021, we had a provision to expect credit losses of $14.4 million against a gross accounts receivable of $32.9 million.

While the same asset property operating income cash basis from our office segment decreased 10 percent, compared to Q1 2020, it is all due to Hess Corp receiving a seven months free rent period as part of a lease extension and amending agreement. This rent free period ends June 30, 2021. Hess will continue to lease two third of the property for an additional 10 year term beyond the original expiry of June 2026.

Excluding the impact of the Hess lease, same asset property operating income from office properties would have increase by two percent. Same asset property coming from our industrial segment decreased 2.3 percent compared to Q1 2020 due to the decrease in occupancy from 99 percent to 97 percent.

Given the pandemic backdrop, we are pleased to report our Q1 2021 FFO was $00.40 per unit compared to $00.45 for Q1 2020. On last quarter's call, we spoke about a few items which were expected to influence 2021 financial results. And I'd like to now review the impact on Q1's results.

Firstly, as our River Landing developments have been completed, this interest has been capitalized to the project. The aggregate interest capitalized on all development projects amounts to $1.6 million for Q1 2021, compared to $5.6 million for Q1 2020. We expect a net drag on FFO until the project achieves stabilized occupancy.

Property operating income from River Landing only amounted to $600,000 USD in Q1 2021. And we expect that to grow to approximately $6,000,000 USD a quarter or $25,000,000 USD annually once the project is fully leased.

Secondly, Jackson Park in Long Island City, New York has been particularly hard hit by COVID, as foreign students left New York and others left for the suburbs. Property operating income on a cash basis for Q1 2020 was approximately $3,000,000 USD at H&R's ownership interest. Prior to the onset of COVID, Q1 2020 property operating income for Jackson Park was approximately $8,000,000 USD at H&R's ownership interest.

We are encouraged by the recent pick up in leasing activity. The vaccine roll out appears to be giving people confidence to return to the city.

And lastly, in January 2021, H&R converted 140 million mezzanine loan on a 12.4 acre development site in Jersey City to an ownership position. This will reduce interest income by approximately $14,000,000 USD annually in 2021 compared to 2020, and interest will not be capitalized on the project until development commences.

Finance income in Q1 2021 was $5.9 million compared to $8.2 million in Q1 2020. While these sectors will temper 2021 results, they're expected to substantially reverse in 2022 with

anticipated lease up in River Landing, Jackson Park, Hercules phase one, and the commencement of future developments. We also expect the development activities to contribute to net per unit growth and improve the overall quality of our portfolio.

And with that, I will turn it back to Tom.

Tom Hofstedter: Thanks, Larry. After a challenging year, we're all finally starting to see promising signs of recovery. We've seen a sharp improvement in lease activity and occupancy at Jackson Park and strong leasing momentum at our largest recent development, River Landing, in Miami.

Vaccination rates are climbing every day, and where restrictions have been lifted, brick and mortar retails sales have surged. Several retail properties are still closed by mandate, but we expect them to reopen over the next 12 months.

We received significant unsolicited interest from many parties looking to acquire a broad variety of our assets, and we expect to complete further dispositions over the next few quarters, taking advantage of the strong demand and pricing to further reduce our leverage.

And finally, we remain committed to maximizing value for our unit holders and continue to work towards opportunities in 2021 to evolve H&R to a more narrowly focused REIT consistent

with investors' preferences. Last quarter, we outlined plans to create at least one new entity in 2021 and remain on track to achieve that goal. And we are currently working on a number of other transactions and initiatives that we believe will materially enhance H&R REIT. We look forward to providing more details in this regard over the course of the summer.

We'd now be pleased to answer any questions from the call participants. Operator, please open the line for questions.

Operator: At this time, ladies and gentlemen, if you would like to ask a question, please press star followed by the number one on your telephone keypad. We'll pause for a moment to compile the Q&A roster.

Our first question comes from Matt Logan with RBC Capital Markets. Your line is open.

Matt Logan: Thank you, and--thank you, and good morning.

Unknown: Good morning.

Unknown: Good morning.

Matt Logan: In terms of your IFRS fair value marks, can you tell us what percentage of the $67 million was driven by your enclosed mall portfolio and what pack rate you're carrying Primaris at today?

Larry Froom: The $67 million was mostly due to the Primaris increase in the malls. When the onset of COVID hit last year, we were very conservative and reduced those cap rates and assumptions in the leasing and the rent rates.

Since then, we've had a few appraisals been done and showed significantly higher than what we were carrying. So, most of that $67 million that you reference was Primaris mall.

What cap rate are we carrying it at? I know in our investor presentation, we had the overall retail--you know, just try and look it up for you now--what overall retail percentage--our cap rate was. I'll get that number to you in a second. But, I don't think we split it up between malls and other retail. Yeah. Overall cap rate of 6.8 percent.

Matt Logan: So, would it be fair to think about the enclosed malls in the order of maybe 100 basis points higher, 50 basis points higher than that average?

Larry Froom: Would it be fair? Yes, I would say yes, at least 100 basis points higher than average.

Matt Logan: And in terms of your fair value mark downs of last year, certainly you were quite conservative in taking about $1.3 billion collective mark downs. Was any of that related to

your Canadian grocery anchored portfolio, or were those assets largely stable?

Larry Froom: No, last year Q1--those assets were stable. We did not take a write down in those assets. Those assets have continued to perform well and maybe even the cap rates have even compressed in them given the demand for grocery these days.

Matt Logan: And if we turn to some of your strategic priorities in 2021, can you talk about how you're thinking about the bow (sp) and maybe give us some insight on where you're carrying that asset in terms of a cap rate today?

Larry Froom: Tom, do you want to take that?

Tom Hofstedter: Well, we've always been working, since the day we built it, actually, to reduce our exposure, as you well know. And it's--we're currently--my reference at the end of--when I spoke about before--references of bow comes critical in achieving our other objectives. So, we are currently working on it. We are in the very advanced stages.

But, regretfully, at this stage of the game, I still can't give you more details. I can say, as I said in the speech, that I expect to--fully expect (inaudible) this year we shall--over the course of the summer, we shall be able to make some announcements.

I have to be vague on purpose. But, we are--this is not something--initiative that we're just looking at right now. We are well advanced in our strategic thinking to where we're--actually strategic plans of where we're headed to.

Matt Logan: (Cross talking) Go ahead.

Tom Hofstedter: Sorry. Larry, you want to give the (inaudible)? What do you want to do there?

Larry Froom: I don't know if we can since we haven't put it in any other disclosures. I don't know if we can give it on a call because it's not equal opportunity.

Matt, I would say--all I can give you a bit of color on is that, again, in Q1 2020, we took a substantial hit. I think it was an excess of $600 million on our office portfolios, specifically relating to oil tenants--oil and gas tenants in that industry in Calgary and in Houston. And of that $600 million mark down, the bow was biggest part of that.

What we're carrying out now we have not disclosed, and I don't know if I can give that. I'm sorry. I don't mean to the vague. We think we've been conservative with the value. We think, whether it's a sale or whatever we end up doing in the future, we'll be able to achieve at least our offer's value, if not quite a bit more.

Matt Logan: Appreciate that. And completely understand. Maybe just changing gears to the residential side of your business, you've had some great leasing traction at River Landing and some very healthy same property and a lot of growth in the Sun Belt Lantower portfolio. Can you give me a sense of what's driving the lease up and, you know, the performance more broadly across the Sun Belt?

Philippe LaPointe: Hey, Matt. So, great question. So, as it relates to your question on River Landing, not to oversimplify the answer, but, frankly, I think that we just have a terrific product. I think the--what was ultimately developed in terms of location but also in terms of finished product and the amenity base that we're able to offer prospective residents in comparison to the submarket is dramatically superior. And I think that plays a--probably an outsized role in the pace of the lease up.

As it relates to Sun Belt, I mean--you know, I don't want to belabor the point. But, I think everyone has kind of read the reports of the net migration from--.

Unknown: --Your call has been placed on hold. Please wait--.

Philippe LaPointe: --Hello?

Tom Hofstedter: Is it somehow--?

Matt Logan: --I'm still here, Philippe--.

Philippe LaPointe: Okay. It rang in my ear--the operator rang in my ear. I think it's just that the resiliency and the strength of the Sun Belt markets. I mean, it's where jobs are being created. It's where the--from a tenant perspective, the income to rent ratio is probably the healthiest in the nation. And, frankly, I think a lot can be said about the taxation or ultimately what the local governments have elected to do to attract those businesses and those tenants.

But, in any event, I think the Sun Belt markets are certainly helping River Landing and attracting the net migration to Miami. But, I think, you know, first and foremost, it really comes down to the quality of the development.

Matt Logan: Appreciate the commentary. And maybe just on that same property, NOI growth transfer for Lantower. There wasn't like a weak comp in the prior quarter. This is a pretty clean year over year figure?

Philippe LaPointe: I'm sorry, Matt. Could you repeat the question?

Matt Logan: When you think about that four percent growth figure, excluding Jackson Park, there was nothing in the prior

period in terms of lease up of certain assets or anything anomalous? That four percent is pretty clean?

Philippe LaPointe: I think, generally speaking, that's true. It's difficult to part them out only because some assets we bought last year were in stabilization at different levels. But, I think, generally speaking, the right way, in my mind, to look at is it, really, that's just generally NOI growth produced with, frankly, a stabilized portfolio. We're generally speaking a generalized portfolio.

Matt Logan: Appreciate the commentary. That's all for me. I'll turn it back. Thank you.

Operator: As a reminder, ladies and gentlemen, to ask a question, please press star then one on your telephone keypad.

And we do have a question from Sam Damiani with TD Securities. Your line is open.

Sam Damiani: Thanks. Good morning, everyone, or good afternoon--wherever everybody is. Just, I guess, on the--well, the bow and then the office portfolio. And I think some of the commentary alluded to this.

But, just with the low industry environment and, you know, investor demand for properties coming back pretty hard in many sectors, you know, do you see some fair value write ups, I

guess, on some of your long term leased office product, you know, in the near term?

Tom Hofstedter: I think the answer is yes. It's a little bit early days. There's a little bit of--a lot of hesitation on the work from home and how that's going to shake itself out. But, you're right, there's a very strong demand. We haven't seen a lot of product change at this point in time. But, I think it's coming.

And so, I expect there to be enough evidence of transactions coming forward. Again, there's been almost nothing going, in the rearview mirror, to actually give us the ability to go ahead and increase our cap rates.

Sam Damiani: Thanks. And--sorry. And sorry. And Tom, just on your comment, you mentioned there's been unsolicited bids for assets and you're looking at stepping up dispositions. You know, in what business segments are you focusing on in the near term in that regard?

Tom Hofstedter: So, it's cross range. It's--we're not culling our portfolio necessarily because we have bad assets or we have--there's tremendous opportunities. Obviously, you have a buyer, which we have right now, and a portfolio of--so, let's say, our investor properties, it has a strategic reason for paying us a solid price, we'd look at that.

Otherwise, we're looking to raise capital to enhance our balance sheet and further go forward with our strategic initiatives. So, it's more of a right across the board. It's not--I don't think it's focused on any one particular sector.

Sam Damiani: Okay. Last one for me is just on the Lantower. I think last call, Philippe--you know, the messaging was pretty clear that some of those developments or most of those developments were, you know, build to sell strategies. Is that still the plan as these projects reach completion and stabilization over the next year or two?

Philippe LaPointe: I think that's a fair statement as it relates to the JV developments, not so much as the--as we regard--we'll remain opportunistic, and we'll want to secure optionality on our own developments in the wholly owned development front. But, those are built to core and meant to come into our portfolio. The JV developments are, generally speaking, yes, meant to be sold at some opportunistic moment.

Tom Hofstedter: Again, the strategy--why we went into those to begin with is it gives us optionality. We get to go ahead and get the--a first crack at buying if we want to buy it.

The challenge today is that the cap rates are so low for the assets we're building that it's even hard even though we have a profit and higher return on our initial investment of,

let’s call it, a third investment on those. Overall, the pricing is still very expensive.

So, that’s why our strategy on the Lantower is more to turn into a developer rather than an acquirer today because caps rates are just, quite frankly--they’re very, very low, and prices are too expensive.

Sam Damiani: Thank you. I’ll turn it back.

Operator: There are no further questions in queue at this time. I’ll turn the call over to Mr. Tom Hofstedter with--for closing remarks.

Tom Hofstedter: Thanks, everybody. And we look forward to, I guess, virtually seeing you at the AGM. Have a great weekend. Bye.

Operator: This concludes today’s conference call. Thank you for participating. You may now disconnect.